

**MINUTES OF THE REGULAR MEETING OF THE
ARIZONA STATE RETIREMENT SYSTEM BOARD**

**HELD ON
August 20, 2004
8:30 a.m., MST**

The Arizona State Retirement System (ASRS) Board met in the 10th Floor Board Room, 3300 N. Central Avenue, Phoenix, Arizona. Dr. Keith Meredith, Chairperson of the ASRS Board, called the meeting to order at 8:33 a.m., MST.

The meeting was teleconferenced to the ASRS office at 7660 E. Broadway, Tucson, Arizona 85710.

1. Call to Order; Roll Call; Opening Remarks

Present: Dr. Keith Meredith, Chairperson
Mr. Karl Polen
Ms. Charlotte Borchert
Mr. Jim Bruner
Mr. Jaime Gutierrez
Mr. Michael Townsend
Mr. Lawrence Trachtenberg
Mr. Steven Zeman

Absent: Ms. Anne Mariucci

A quorum was present for the purpose of conducting business.

2. Approval of the Consent Agenda

Motion: Mr. Karl Polen moved to approve Refunds, Death Benefits, and System Transfers,

And

Approve the minutes of the July 16, 2004, regular and executive session meetings of the ASRS Board,

And

Approve the Notices of Rulemaking Docket Opening for employee eligibility; withdrawal of contributions.

By a vote of 7 in favor, 0 opposed, 0 abstentions, and 2 excused, the motion was approved.

3. Presentation, Discussion and Appropriate Action Regarding Facilitation of Member Association Contact with Members

Mr. Lawrence Trachtenberg arrived at 8:40 a.m.

Mr. Paul Matson, Director, provided brief background information for this item. The ASRS Board approved a policy and procedure at its April 16, 2004, Board meeting to allow for a bona fide, not-for-profit member association group to communicate with ASRS members, both active and inactive and by utilizing ASRS resources such as providing a link on the ASRS Web Site and providing contact information of member association groups in the ASRS newsletter.

Several member association groups have asked for additional information to allow them to contact ASRS members. Specifically, these groups have requested access to either member contact information or blind mailing services to assist in dissemination of information to ASRS members.

Mr. David Mendoza, Political Director, American Federation of State, County, and Municipal Employees (AFSCME), addressed the Board regarding this item. Mr. Mendoza requested that the ASRS facilitate a blind mailing and asked the Board to consider the request as it would improve AFSCME's communication with the members. He stated policies and procedures would be put into place to maintain the confidentiality of this sensitive information.

Mr. Jaime Gutierrez asked for the definition of a bona fide, not-for-profit member association group. Mr. Matson stated that the ASRS' public relations officer would have to make the determination on which groups fell into this category.

Ms. Charlotte Borchert asked who would maintain the list of members to receive information and who would absorb the costs associated with this process. Mr. Mendoza stated that in this situation, AFSCME would be responsible for the costs.

Dr. Meredith asked the Board if they would entertain a motion to revise the current policy and procedure to allow member association groups to have access to member information or utilize the blind mailing process. Members of the ASRS Board did not move for a motion so Dr. Meredith stated that the policy and procedure would remain unchanged.

4. Presentation, Discussion and Appropriate Action Regarding the Notice of Rule Making for R2-8-202, Actuarial Assumptions and Table 1

Ms. Nancy Johnson, Rules Coordinator, stated that R2-8-202 will change the mortality table for System members. The ASRS Board approved this change on May 21, 2004. A Notice of Docket Opening and a Notice of Proposed Rulemaking have been filed and oral proceedings were held on August 9, 2004. No comments were received during these proceedings.

Motion: Mr. Jim Bruner moved to approve the Notice of Final Rule Making for R2-8-202, Actuarial Assumptions and Table 1.

Mr. Jaime Gutierrez seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

5. Presentation, Discussion and Appropriate Action Regarding the Procedure for Handling Member Appeals to the ASRS Board

Mr. Richard Stephenson, Deputy Director, External Affairs, stated that approximately one year ago, the ASRS Board approved a policy that provided all Board appeals be sent to the Office of Administrative Hearings (OAH), if these appeals were evidentiary and factual in nature. All other types of appeals would be heard by the ASRS Board. The External Affairs Review Committee (EARC) reviewed this rule and decided that the Board should be presented with the opportunity to review this rule and consider having all appeals initially sent to OAH. Mr. Stephenson added that all decisions by OAH are recommended actions and these appeals would be returned for review by the ASRS Board for final action upon completion of OAH's review. The ASRS Board would be obligated to review all evidentiary materials for the appeals in which the Board decided to not accept recommendations from OAH.

Ms. Johnson added that allowing OAH to review all appeals will free up the Board's time to tend to other matters. Also, this will allow for all appellants to be treated in the same manner.

Mr. Jim Bruner stated that he is not sure that the ASRS needs to make a distinction on which appeals go to OAH and which appeals are reviewed by the Board. Mr. Bruner also said the Appellant should have the opportunity to appeal these decisions and request a re-hearing.

Mr. Fred Stork, Assistant Attorney General, added that if the Appellant is not satisfied with the outcome of his or her appeal, they have the option of appealing to the Superior Court for judicial review of the Board's decision. The issue is whether or not the Board wishes to reserve for itself hearing particular cases without any previous proceeding in front of an administrative law judge at OAH or does the Board wish to have all appeals reviewed by OAH.

Ms. Charlotte Borchert inquired as to who incurs the costs for the appeals that are sent to OAH. Ms. Johnson replied that the ASRS incurs these costs and the cost is approximately \$500 per day, with most matters taking less than a day to decide. Ms. Borchert does not agree with sending appeals that do not have a factual issue to OAH.

Mr. Lawrence Trachtenberg inquired as to what expertise the ASRS Board has in deciding issues of law. Mr. Stork replied that according to State statute, the ASRS Board has the authority to interpret the law, however, the statutes do not address the level of expertise the Board must have in order to make these decisions.

Dr. Bev Cuthbertson, All Arizona School Retiree Association, asked if the process at OAH will meet the timeline stated in the statute and if the hearings at OAH are open to the general public. Per Ms. Johnson, witnesses are excluded from the hearing, however, the hearing is open to the public. The timeline is based in statute and in rule, and are similar for both the Board and for OAH. Appellants also have an option to ask for a re-hearing or review by the Board or OAH. Generally, this is done without an additional hearing. Per Mr. Stork, a member who files an appeal has the right to hear a response to the appeal within 60 days of filing. Additionally, the

member has the right to receive notice of the hearing 20-30 days prior to the hearing. These statutes apply to both OAH and to the ASRS.

Motion: Mr. Karl Polen moved to approve the procedure that all Board appeals be heard by an administrative law judge with the Office of Administrative Hearings.

Mr. Jim Bruner seconded the motion.

Ms. Borchers opposed this motion.

By a vote of 7 in favor, 1 opposed, 0 abstentions, and 1 excused, the motion was approved.

6. Presentation, Discussion and Appropriate Action Regarding the Notice of Rulemaking Docket Opening and Proposed Rulemaking for New Article 4, Practice and Procedure

Ms. Johnson referred to Packet A, which contains a Notice of Rulemaking Docket Opening and Proposed Rulemaking providing all appeals to the Board will be sent to OAH.

Motion: Mr. Polen moved to approve Packet A, the Notice of Rulemaking docket Opening and Notice of Proposed Rulemaking for new Article 4, Practice and Procedure that provides that Board appeals be heard by an administrative law judge with the Office of Administrative Hearings.

Mr. Bruner seconded the motion.

Ms. Borchers opposed this motion.

By a vote of 7 in favor, 1 opposed, 0 abstentions, and 1 excused, the motion was approved.

7. Presentation, Discussion and Appropriate Action Regarding the ASRS Budget Request for FY06/07

Ms. Borchers, Chairperson, Operations Review Committee (ORC), thanked the members of the ORC along with Ms. Sara Orozco, Senior Management Analyst, and other ASRS staff for all their hard work on the FY 06/07 budget request.

Motion: Ms. Borchers moved to approve the appropriated budget request for FY06/07.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

8. Presentation, Discussion and Appropriate Action Regarding Changing the Accrual Rate on Account Balances from 8%

Mr. Matson stated that contribution rates are expected to increase. The ASRS Board and staff have been working together to find a solution to keep these increases to a minimum. One solution would include decreasing the credited accrual rate to member balances to 4%. Currently the accrual rate is set at 8%.

In order for any change in accrual rates to affect the July 1, 2005 contribution rate, a Board decision would be required by approximately September 2004.

Mr. Charles Chittenden, ASRS Actuary, Mellon Human Resources and Investor Solutions, provided a presentation on actual and scenario statistics in crediting interest on balances at both 4% and 6%.

Dr. Bev Cuthbertson, All Arizona School Retirees Association, had a question regarding how the Government Accounting Standards Board (GASB) status and the market value status will effect the ratings. Mr. Chittenden responded that the investment losses that the Fund has experienced during 2001, 2002, and 2003 are being reflected over a period of time. This means that the affect of those losses has not been fully reflected in the numbers which determine the 5.2% contribution rate. When these numbers are fully recognized, it is then fully paid and amortized over a rolling 30-year period. Mr. Chittenden stated that he reports the GASB numbers and then these numbers are turned over to the accountants.

Motion: Mr. Karl Polen moved to change the accrual rate on member balances to 4%, effective July 1, 2005, for purposes of determining member withdrawal amounts.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

9. Presentation, Discussion and Appropriate Action Regarding the Total Fund Performance Overview for the Period Ending June 30, 2004

Mr. Terry Dennison, Principal, Mercer Investment Consulting, presented an economic and market review and reported on the Total Fund for the period ending June 30, 2004.

	Quarter	1 Year	3 Years	5 Years	Inception
Total Fund	0.1%	17.5%	3.3%	2.5%	11.0%
Benchmark*	0.3	15.7	2.8	1.3	9.2
RM Public Funds Median	-0.1	17.5	4.5	4.1	
Percentile Ranking	38	51	92	96	

*Interim Benchmark of 56% S&P 500/28% LB Aggregate/16% EAFE, which incorporates a proration of 6% real estate.

Policy History:

1/1/89-12/31/91 is 60% S&P 500/40% LB Aggregate,

1/1/92-12/31/94 is 50% S&P 500/40% LB Aggregate/10% EAFE,

1/1/95-6/30/97 is 45% S&P 500/40% LB Aggregate/15% EAFE,

7/1/97-12/31/99 is 50% S&P 500/35% LB Aggregate/15% EAFE,
1/1/00-09/30/03 is 53% S&P 500/30% LB Aggregate/17% EAFE,
10/1/03-Present is 53% S&P 500/26% LB Aggregate/15% EAFE/6% Custom Real Estate Benchmark

10. Presentation, Discussion and Appropriate Action Regarding Fixed Income Investment Manager Review

Mr. Gary Dokes, Chief Investment Officer, and Mr. Dennison provided a review of the fixed income portfolios, managed both internally and externally.

BlackRock Asset Management outperformed the Lehman Brothers Aggregate Bond Index (LBAGG) for the quarter, one year, three year, five year, and since inception time periods. Retention is recommended for this investment manager.

Fidelity Investments matched the return of the LBAGG for the quarter and underperformed the index since inception. Performance history is too short to make a recommendation at this time but performance improvements will be expected for the upcoming quarters.

JP Morgan outperformed or matched the return of the LBAGG for all time periods reported except the quarter. No changes are recommended at this time but there is concern with recent organizational changes to the firm. Ms. Patti Cook joined JP Morgan 16 months ago as the Chief Investment Officer of the New York and London fixed income teams. In July 2004, Ms. Cook announced her departure from the firm just as Ms. Cook had begun to make a positive impact on the process and the overall morale of the team.

Barclays Global Investors (BGI) is tracking the LBAGG as expected. Retention of this manager is recommended at this time.

The ASRS F1 portfolio underperformed or matched the LBAGG for the quarter, one year, three year, five year, and inception time periods. Termination of this portfolio is recommended by ASRS Investment Management Division due to performance and operational issues.

The ASRS F2 portfolio underperformed the LBAGG for the quarter, one year, three year, and inception time periods. Retention of this portfolio is recommended at this time because the performance of F2 has been the result primarily of poor security selection and less than optimal use of the available portfolio parameters. Given the proposed outsourcing of the ASRS F1 portfolio and the acquisition of improved bond analytics, an improvement in the F2 portfolio is expected over the next 12 months.

Mr. Bruner stated he was unsure of the recommendation to terminate the F1 portfolio as the performance is almost identical to the performance of the F2 portfolio. Mr. Dokes stated there is more of an issue with F1 because over the last six years it has been very difficult to mirror the index with the dynamics of the market. There had been some issues with bond analytics and security selection that are currently in the improvement stage.

Mr. Polen inquired why the issues with the F2 portfolio are considered to be on a short-term basis. Mr. Polen noted that the F2 portfolio has underperformed 11 quarters of the 15 quarters

that the portfolio has been existence. There has not been a period where this portfolio consistently outperformed the index. The inception-to-date underperformance has been about ten basis points compared to approximately four to five basis points for the F1 portfolio. Mr. Dokes responded by saying he is looking at this issue from the operational standpoint as well as performance.

Dr. Meredith asked why the ASRS should evaluate the F2 portfolio for another year. Perhaps this portfolio should be evaluated in six months. Mr. Dokes informed Dr. Meredith that this portfolio is monitored on a quarterly basis.

Motion: Mr. Bruner moved to approve the termination of the ASRS F1 passive fixed income portfolio,

And

To authorize the Investment Management Division (IMD) to transition approximately \$186 million of F1 securities/cash to ASRS' existing Global Tactical Asset Allocation (GTAA) managers,

And

To authorize IMD to transition the remainder of F1 securities/cash (approximately \$914 million) to BGI's enhanced U.S. debt index fund,

And

To approve the retention of ASRS' three active managers, as well as the ASRS F2 portfolio and BGI's passive index fund.

Mr. Steven Zeman seconded the motion.

By a vote of 8 in favor, 0 opposed, 0 abstentions, and 1 excused, the motion was approved.

Mr. Polen noted that although he questioned Mr. Dokes on this recommendation, he concurs with it and expressed the importance of retaining in-house expertise. Mr. Trachtenberg, Chairperson, Investment Review Committee, added that this portfolio will continue to be monitored by the IRC.

11. Director's Report

None.

12. Possible Presentation and Discussion Regarding Board Committee Updates

Mr. Gutierrez, Chairperson, External Affairs Review Committee (EARC), referred to five public policy initiative drafts that are currently under review by the EARC. The EARC plans to bring

final recommendations to the Board at its September meeting. The drafts have been given to the Board for comments or questions.

Mr. Lawrence Trachtenberg, Chairperson, Investment Review Committee (IRC), stated the IRC is currently in the search process for a small cap growth manager.

Ms. Charlotte Borchert, Chairperson, Operations Review Committee, stated an update/review on the Information Technology (IT) Plan will be given at the ORC's September meeting.

13. Board Requests for Agenda Items

None.

14. The next ASRS Board meeting is scheduled for Friday, September 17, 2004, at 8:30 a.m., at 3300 North Central Avenue, 10th Floor Board room, Phoenix, Arizona.

15. Adjournment of the ASRS Board

Dr. Meredith adjourned the August 20, 2004 Board meeting at 11:17 a.m.

ARIZONA STATE RETIREMENT SYSTEM

Marina Chaves, Secretary

Date

Paul Matson, Director

Date